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Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW,
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regs.comments@federalreserve.gov Docket No. OP-1461

RE: Proposed Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of more than $10 Billion but less than $50 Billion

Thank you for the opportunity to comment on the Proposed Supervisory Guidance.

The comments on the five questions share a common theme. Three points frame this theme:

- **First, the Guidance is founded on solid principles (p 16).**
  - Strong points in the Guidance include:
    - Openness to using any appropriate practices (§I p16)
    - Recognition of range of company-specific factors ((§I p16)
    - Scope limitation that the document is not comprehensive (§I p16)
    - Recognition of broader risk to a company § IV E, pp44-45
    - Cautions on assumptions (§ III C, p22), especially proxy data and need to challenge past experience (§ III C 2, p24). This is emphasized with multiple cautions on use of historical data.
    - Concern with cost effectiveness in credit loss modeling (§ IV C 4, p31)
    - Explicit permission to link to the budgeting process (§ IV C, p29)
  - Some of the most forward-looking points are references to "company's core businesses and earnings capacity" (§ III C 6, p36) that provides focus on business model; and to overall strategy and business plans (§ IV E, p44).
- **Second, as with the past decade of struggles in financial institutions, achieving the aspirations of the Principles is likely beyond reach because implementation details are often at odds with the Principles.**
  - Basel Accords have also struggled with similar challenges.
    - The Accord's principles and some implementation were written with a forward-looking industrial systems approach to reducing risk to the quality of *future* products

and operations. Yet, later drafts introduced a backward-looking view of risk to reporting *previous* transactions.

        - The difference is dramatic -- managing risk to the circus trapeze performers flying over hungry lions versus counting the cash box.

    - Structural barriers to successful implementation of the Principles include:
        - Using compliance-oriented risk management methods. These tend to be more proximate cause, backward-looking, associative and/or loss event-oriented.
            - Such measures are often disconnected from forward-looking risk to business objectives such as making good loans and generating cash flow.
                - Capital model error ranges expand when proxy and synthetic data is used. This is simply because of the assumption that such data reflect real-life, specific environments faced by, and capabilities of each company. Such an error would not be made by a face-painted football fan in a sports bar comparing two teams. Why should it be acceptable in banks?
            - Such approaches usually misapply tools designed for credit risk or audit of internal controls to strategic or operational risk (including operational risk from strategic overreach).
                - For example:
                    - Struggles to determine "risk appetite." "Appetite" has little meaning outside business performance *objectives*. Objectives only have risk in the context of some environment and capabilities as described in scenarios. It is easy for a football player to run a football into the end zone on an empty field on a nice day.
                    - IT-related risk. Company operations, especially information technology capabilities and digital geographic footprint (i.e., customer and data center locations), are critical dependencies. Without adequate or robust operations, there is no financial company. Technology is all about systems – motion pictures such as *Apollo 13* or the *Ocean's* series use this point for dramatic effect. Tools designed for managing risk in systems (not credit or reporting audits) are required.
                - These approach/method/tool problems then pass inadequate data into capital adequacy models.
        - Emphasizing the capital adequacy model over the *business* model. Excessive focus on capital adequacy risk model has distracted from managing risks to business model strategy and execution. As a small retailer knows, an inventory credit line, while important, is no substitute for selling the right products at the right location. The wrong focus not only wastes cost, but also can be dangerous when model-mickeying distracts management from looming risk.

- Putting blinders on, rather than taking them off.
  - Limited dimensions of banking risk management scenario analysis (a tiny fraction of scenario analysis used in other professional disciplines and industries, including federal government), proximate cause and use of synthetic data all create blinders to seeing lurking risk simply because they screen out causal information. A flat car tire is a shock if a person is ignorant of nails.
  - Sensitivity analysis with economic variables doesn't provide the bright light of life-like stories of situations unfolding from dark corners. Such stories challenge users to thoroughly ask "what if?" and prepare for the "bad thing."
  - Worse, when combined with other risk blinder-creating tools such as risk registers, RCSAs and frozen heat maps, the result is usually a false sense of security and potentially dangerous distraction from real risk. In teaching teenagers to drive, scanning everything on the road keeps people alive.
- Reinforcing bad habits. These structural problems and related skill gaps are passed on from one person to another within organizations. At each step, the mechanistic implementation in both governance and management gets farther from the aspirations of the Principles. Of course, skill gaps at the executive level tend to cascade most throughout an organization.

- These barriers are especially problematic for companies in this size category as they lack the scale to absorb the compliance overhead, are being relied upon to drive economic growth, and are undergoing significant business model change due to margin pressure, new products, technology and M&A.
- All these challenges come when the three most critical processes in a bank are operational: organization change, product management and business-IT management. It is through these three processes, which enable all other processes, that risk to objectives (for customers, investors, regulators, guarantee funds, taxpayers) is managed.
  - Operational risk is central as it both:
    - Reflects risk to implementation of business model
    - Is the execution on which market, liquidity and credit risk depend
      - A company is entirely dependent on operations, including data and IT processing capabilities.
  - Yet, the typical capital model is not structured to interact with these forward-looking product and operational considerations.

- **Third, the good news is that overcoming these frustrating barriers is readily possible by extending the Principles in three ways:**
  - Begin with a systems perspective seeing the interconnectedness of a company's environment and business capabilities (oversight, management, business process and controls).

  - Embed risk oversight and management into daily business decisions and activities (as emphasized in Principle 4, p16) as is done in other industries. Such an approach brings a more root cause, forward-looking and situation-in-time perspective. This not only makes a strong linkage to actually managing risk to business objectives, but also has potential for significant cost savings for smaller companies simply because it dovetails risk management with business performance management. This also minimizes governance and compensation misalignment.
  - Center that embedded risk oversight and management on the design and daily execution of the banking business model – especially as it is changing and more complex.

Question Responses

- Question 1. These challenges and complications in tailoring are significant problems IF the more backward-looking, loss event-oriented approach is taken. However, IF the Principles (p16) are supported with the more forward-looking, systems-based approach, then these challenges will diminish because the needed tailoring will: a) be more clear through more life-like scenarios and b) managing risk to business performance (as defined in business plans and expectations communicated to investors) will naturally be more integrated with the risk model. Suggested improvements:
  - Revise throughout to emphasize performance-driven management of risk -- the more forward-looking, embedded, systems-based and business model-oriented approach.
  - Simplify the regional tailoring by providing: 1) starting assumptions that are more applicable to these companies and 2) a timely method to review/approve company tailoring *prior to* a company spending the cost to finalize.
- Question 2. Yes, simply make the primary approach forward-looking as in Principle 3 (p16), rather than the backward -looking emphasis (despite the document's several cautions). Suggested improvements:
  - Focus on risk evaluation based on *realistically asking "what if?"* to understand risks lurking in the environment and business capabilities (including capabilities of parties who would maliciously or unintentionally engager a company).
  - *Strengthen existing cautions* on use of historical data and state the need to justify reasonableness of extrapolating from past data into the future.
  - Likewise, state the need to *justify proxy data* based on the expected future state of the environment and business capabilities.
- Question 3. Suggested improvements:
  - Companies to describe how risks common to *any* vendor managing any business activity are being managed for the third-party DFA stress test vendor.
  - Companies to describe, in the context of the unique role of stress test modeling, the ability of a third-party to *sufficiently understand the company's specific environment and capabilities*; dependency risk on the company's specific software, configuration, equations,

people and locations; and why using a third-party to manage the model does not cause a disconnect from the company's daily activities to manage risks to performance objectives.

- Question 4. This situation would be helped by the improvement in reply to Question 1 -- to shift to an approach that is more deeply *embedded in daily business*, including the financial and operational performance management tools. This is simply because the risk model would then be more integrated with tools already used for company modeling and reporting.
    - Additional suggested improvement: Graphically present the table in a way that is similar the primary supervisor tables found on some agency websites.
- Question 5. Summarizing the above comments, suggest communicating to boards and management that:
    - A <u>system-based approach</u> is <u>embedded into daily decisions and activities</u> that design or execute the <u>business model</u>; and that this information flows to the risk model.
    - It is acceptable (if not encouraged) to integrate risk modeling into normal business modeling and reporting of financial and operational performance. Better outcomes for all, lower costs for banks.

Suggest Resources:

- Operational Risk: A Simpler Starting Point for Capital Modeling and Estimation, Gabriel David and Brian Banrier, GARP, March 2013. http://www.garp.org/risk-news-and-resources/2013/march/a-simpler-starting-point-for-capital-modeling-and-estimation.aspx
- The Operational Risk Handbook, Brian Barnier, Harriman House, Great Britain, 2011
- ICGN Dialogue in Corporate Governance: Risk Oversight, a six page guidance document for investors to use in evaluating company risk oversight. https://www.boardmember.com/Article_Details.aspx?id=9994

Respectfully submitted,

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